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FOREIGN DIRECT INVESTMENT IN JAPAN: 1985 UPDATE

Summary

Foreign direct investment in Japan continued to swell in 1984 as a recovering domestic economy enhanced the financial environment. Although the number of inward investments skyrocketed, the total apparently declined. Japan's attitude toward foreign investment continues to improve; both national and local governments have established investment promotion offices aimed at domestic and foreign firms. In addition, Tokyo recently announced that it would reform the regulations governing foreign direct investment to make it even easier for companies interested in operating in Japan. Important psychological and cultural hurdles remain, however, making direct investment no guarantee of success in Japan's market.

Introduction

The Japanese government's receptivity to foreign direct investment exhibits a spotty record. Given the extreme demands on foreign currency and domestic resources immediately after World War II, restrictive foreign exchange and investment regulations to defend the value of the yen and prevent excessive repatriation of profits were understandable. Equally understandable was the slow pace of liberalization once Japan joined the Organization for Economic Cooperation and Development (OECD). Although OECD guidelines mandate a certain degree of openness in the foreign investment regulations of member countries, they do not include any rigid timetables or penalties for noncompliance. In light of the tight regulation of domestic financial institutions and the economy's rigid financial structure, the Ministry of Finance (MOF) felt justified in extending its stranglehold to foreign investors.

More important, however, were Tokyo's infant industry policies that protected selected industries from overwhelming foreign competition. Aided by the Finance Ministry, the Ministry of International Trade and Industry hoped to foster industrial development by closing some sectors to foreign investment, forcing foreign firms to form joint ventures with Japanese companies in other areas, or exchanging technology licenses for investment permission. It is important to remember, however, that these policies were not applied across the board. Foreign investment in many light manufacturing industries and food product lines was relatively open. The close scrutiny and labyrinthian procedures, however, were sufficient to chill many potential investors' interest in Japan.

Since 1980, when full compliance with OECD foreign investment guidelines was achieved, there has been a sharp change in Japanese attitudes toward foreign investment. Slower economic growth is one major reason for the change -- Japanese policymakers realized that they were denying the economy a source of economic stimulus. The growth of private domestic investment fell dramatically from the high levels of the 1960s and early 1970s, although it has partially recovered during the current economic upturn. Foreign investment, while no rival to domestic investment, can augment this important component of growth.

Public spending in rural areas has been one victim of Tokyo's efforts to control the central government budget deficit, creating another opening for foreign firms. In order to sustain growth in rural areas, central and local government officials have broadened the scope of promotional efforts to include foreign investors. Several of Japan's prefectures have mounted investment promotion missions to the United States and Europe -- an unheard-of activity as recently as five years ago.

On a broader scale, Prime Minister Yasuhiro Nakasone's administrative reform campaign is attacking what foreign observers have long listed as the main obstacle to investing in Japan: a highly intrusive central government. Deregulation of many areas of finance and industry should not only make it easier for domestic companies to grow but also improve the opportunities for foreign investors.

Investment Promotion

As for specific promotional programs, the central government offers a site-survey service that finds the best match between foreign investors' requirements, local infrastructure, and human and natural resources. The "Technopolis" rural development plan, "Teleopolis" integrated communications project and ocean resource exploitation programs have also attracted attention from abroad. Foreigners are welcome in Tokyo's dream of creating pockets of high technology industry throughout the country.

In an effort to ease the investment process by reducing the amount of paperwork required, MOF has announced simplified notification procedures for foreign investors. The package of changes to the Foreign Exchange and Foreign Trade Control Law, which took effect July 1, allows investment activity to

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begin immediately after papers are filed with MOF and any other relevant ministry -- eliminating the usual two-week waiting period. The changes apply to all industries except agriculture, forestry, fisheries, leather and leather goods, mining and oil, where foreign investments are still subject to case-by-case approval.

Japan's most recent "action program" of liberalizations also contains measures to encourage investment. In addition to continuing and strengthening information services, Tokyo will piggy-back a new Industrial Cooperation Information Service Desk onto the Japan External Trade Organization's (JETRO) special industrial cooperation project. The new desk, to be opened at JETRO offices in major cities around the world, will provide information and consulting tailored to individual company needs. The government will also increase the amount of low-interest Japan Development Bank loans available to foreign investors.

Private financial institutions are also becoming increasingly involved in promoting two-way investment flows. Sanwa Bank Ltd. signed an agreement August 8 with the State of Alabama institutionalizing the exchange of investment information. Alabama-based firms now have a excellent source of information and counsel in Japan's fifth-largest bank. This is the first agreement of its kind between a Japanese bank and a state government and both sides expect cross-investment to pick up. If it proves successful, other banks will undoubtedly follow suit.

Not all promotion efforts originate in Japan: nearly half of this country's state governments maintain representative offices there. Although primarily meant to attract Japanese investment to the United States, they also serve as a source of first-hand information to interested American companies. The largest U.S. business organization in Japan, the American Chamber of Commerce in Japan, also expends a great deal of effort promoting two-way direct foreign investment. European governments, too, provide information services to their nationals through representative offices in Japan, although again, their main function is to promote investment in the opposite direction.

The Record for 1984

All these efforts have had a mixed impact on investments flowing into Japan. Although detailed information has not yet been released, foreign direct investment in fiscal 1984 (April 1, 1984 to March 31, 1985) totaled 3,685 cases valued at $493 million according to preliminary Finance Ministry data. In fiscal 1983 by comparison, the tally came to 2,363 cases valued at $819 million. It is clear that there has been an impact on the number of investments rather than on their value. If one looks farther back this pattern holds true -- there were only 1,052 cases worth $749 million in fiscal 1982 and just 919 cases valued at $432 million in fiscal 1981.

It is important to note that the Finance Ministry figures that form the basis for this data are derived from the foreign investment notices filed with the ministry. Although the figures cover all sectors, including distribution, services and manufacturing, there are two major caveats to these statistics. First, there is no verification of the investment by MOF officials. Given the tortuous negotiations that precede an investment, it would not be surprising to

find that many prospective deals ultimately fall through. Second, the notifications are submitted in Japanese and translated into English by the ministry. There has been no effort on the author's part to verify the names, value or current status of the investments as reported by MOF. Thus while the information can serve as a good indication of trends, it is imperative to keep these points in mind.

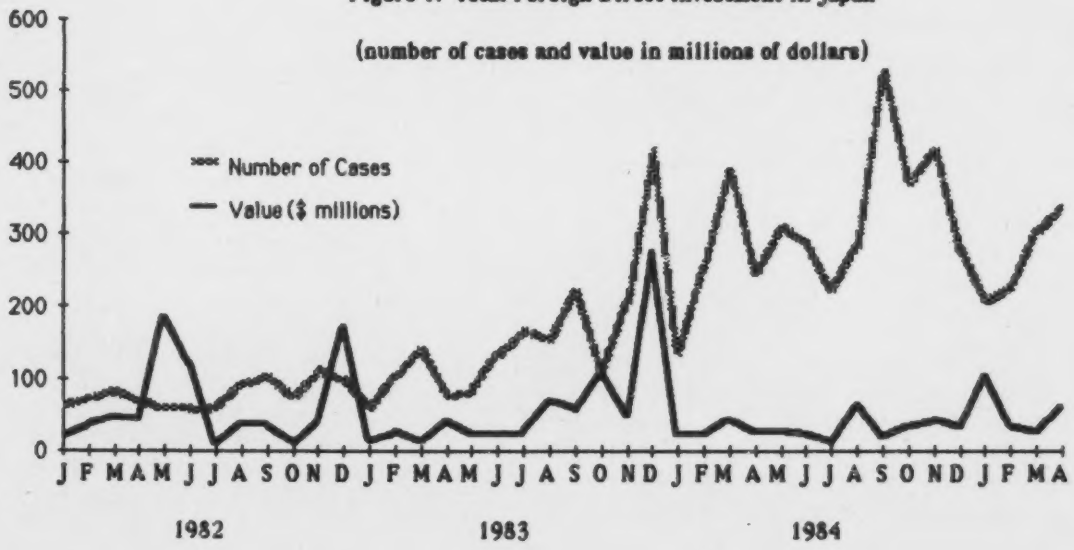
Furthermore, MOF's foreign investment classification guidelines differ from standard U.S. practice. MOF considers investments valued at less than 10 percent of a company's outstanding stock or led by investment brokers as direct investments rather than portfolio investments. In fact, MOF classifies investments over Y100,000 ($2,500) as "major" and does not even consider the percentage. Another important difference is that MOF does not include reinvestment by foreign subsidiaries; investments funded with retained earnings or with locally obtained financing can be quite significant. For these reasons, the Japanese data can present a confusing picture.

An overview of monthly data supports the conclusion that the average monthly value of foreign investments in Japan has held steady while the number of investment cases has risen dramatically (see Figure 1). Small investments clearly constitute the vast majority of cases, pushing down the average investment's value in the past three years from $712,000 in fiscal 1982 to $347,000 the next year and finally to $134,000 in FY 1984. U.S. Commerce Department data, although calculated on a different basis, also indicate that U.S. investment in Japan was flat last year.

The reasons for this are unclear. One possibility is that foreign firms are purchasing a small amount of stock as a sign of good will or sincerity while negotiations are in progress. In other cases, perhaps, large amounts of

Figure 1: Total Foreign Direct Investment in Japan

(number of cases and value in millions of dollars)



funds are not necessary. This is particularly true of the service and distribution (wholesale/retail) sectors where the majority of investments are made. There are also cases where individuals are trading their expertise for an equity stake in the venture. Furthermore, nearly all the Fortune 500 companies already have a Japanese subsidiary and see no need for a new venture, especially in light of the relatively high cost of raising funds in the United States. Since detailed data on all investments are unavailable, the mystery of the incredible shrinking investment remains unsolved.

An analysis of the information that is available is enlightening nonetheless. By country of origin, the United States retained its premier position in calendar year 1984, accounting for 32.6 percent of all investments by cases and 53.4 percent of the total value (see Tables 1 and 2). While still far behind the United States, European investors increased their share of the action in 1984. The shares of Asian countries, on the other hand, did not experience significant growth. Investment from Africa and the Middle East actually declined.

The mix of investor types points to new developments. Individual investors continued to be active in 1984, making slight gains in both cases and value. Investment houses sharply increased their share of cases, especially in the last months of 1984 when they accounted for as much as half of the total. There were a number of prominent investments in late 1984, as giants such as American Telephone & Telegraph Co., General Electric Co. and others took preparatory steps toward entering the soon-to-be deregulated domestic telecommunications market. In general, however, there was no rush into Japan's markets by large foreign corporations.

By type of investment, the establishment of new firms remains ahead in both numbers of cases and total value. One interesting point is that more foreign firms bought out their Japanese partners in 1984 compared with the previous year. This may present an unbalanced picture, however, because there are no statistics on how many foreigners liquidated or reduced their Japanese holdings. Hence, it is possible that these were more numerous and of greater value than the cases in which investors increased their shares.

The distribution of investment by sector and industry (Table 3) provides some interesting figures. Wholesale trade is clearly the most popular endeavor, followed by services (particularly business services) and manufacturing. No one particular product dominates the wholesale trade category, but financial and computer firms account for the majority of service sector investments. Investment in manufacturing seems evenly balanced between companies providing intermediate goods and those in high technology fields, particularly electronics.

Overview and Conclusion

Global money markets were in turmoil for much of 1984, as the vagaries of the U.S. dollar against other major currencies attested. In view of the unusually large differentials between U.S. interest rates and those obtainable in Japan (and elsewhere for that matter), it is not surprising that inward investment experienced little growth in value. This presents Japanese policymakers intent on promoting foreign investment with difficult choices: how much

money are they willing to spend to attract investment from abroad, and who should they target?

Clearly it takes money, tax incentives and subsidized loans, for instance, to make money (increased investments). Under Tokyo's strict fiscal austerity program, however, there is little leeway for new incentives or loans. Although the number of investments from all sources has been rising, these have generated little recognition because the individual investment is small. Should Tokyo court a handfull of large companies in an effort to achieve a strong demonstration effect, or should officials continue a hands-off approach? The lack of consensus on these questions may limit the effectiveness of investment promotion programs.

An overview of investment trends by country of origin yields two points. First, the United States' share of investments is slowly shrinking, even though its absolute value continues to increase. This reflects the relative increase of investments by European and Asian countries rather than a decline of funds flowing from America. While this provides some encouragement to Japanese officials, it will be a long time before investments from other countries rival the amount of money coming from the United States. Second, it appears that the opportunity to attract petro-dollars from Middle Eastern countries has passed. Oil-producing states, once flush with investment dollars, experienced declining sales and prices in 1984. Coupled with continued high government spending, this downturn makes it unlikely that they will channel any significant amount of capital into Japan.

The predominance of investments in non-manufacturing enterprises has interesting implications. If the goal of Japanese officials is to maximize the employment and growth effects of foreign investment, then the service sector dominance is of some concern. Manufacturing operations demand inputs of raw and intermediate goods as well as labor, making a stronger impact on other parts of the economy than service companies, which generally require mostly labor input. On the other hand, the large number of new service and trading companies may help to increase imports into Japan, easing trade frictions. Of course, this requires that there be enough small companies to make a dent in the trade statistics, which could take several more years. Finally, the lack of manufacturing investment highlights the unwillingness or inability of foreign companies to make a serious commitment to the Japanese market.

An important exception, however, is the upward trend of high technology investments. Reflecting the caliber of Japanese expertise in this sector, an increasing number of foreign firms view participation in Japan's market as vital to their competitive strength. Here too, however, there is a lack of heavy investment by large firms, with the exception of some specialized-chip makers, semiconductor production equipment makers and pharmaceutical companies. Recent filings by U.S. high technology industries for protection from Japanese competition, however, underscore the difficulties of successfully penetrating that country's markets.

In conclusion, although most of the legal hurdles to foreign direct investment have been eliminated, firms abroad are still hesitant about sinking money into Japan. The problems they face stem in large part from cultural differences. Foreign firms have difficulty in attracting skilled labor and

obtaining local financing because they lack an established reputation in Japan. The principal way to develop that reputation is to accept losses in the short run without stinting on quality, advertising and after-sales service -- a business plan that is rare among Western companies. Furthermore, even some established firms are having second thoughts. Local production has not yielded significant market-share gains for Texas Instruments Inc., even though its Japanese subsidiary is quite profitable. Breaking into markets where established buyer-supplier relationships exist is very difficult, even with local production facilities. Therefore, while foreign direct investment in Japan will continue to expand, growth is likely to be moderate.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Major Direct Foreign Investments in Japan by Country and Category, 1983*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y89,870.5 (75.3%)	226 (35.4%)	Y55,393.1 (87.6%)	124 (38.6%)	Y4,752.5 (48.8%)	47 (25.4%)	Y29,725.0 (64.0%)	55 (41.4%)
Canada, Central & South America	5,482.0 (4.6)	59 (9.2)	3,734.6 (5.9)	17 (5.3)	642.4 (6.6)	29 (15.7)	1,105.0 (2.4)	13 (9.8)
United Kingdom	3,041.2 (2.5)	60 (9.4)	718.6 (1.1)	23 (7.2)	1,321.4 (13.6)	22 (11.9)	1,001.2 (2.2)	15 (11.3)
West Germany	2,240.9 (1.9)	39 (6.1)	585.0 (0.9)	20 (6.2)	108.9 (1.1)	7 (3.8)	1,547.0 (3.3)	12 (9.0)
France	484.2 (0.4)	26 (4.1)	295.4 (0.5)	14 (4.4)	56.5 (0.6)	7 (3.8)	132.4 (0.3)	5 (3.8)
Other Europe	8,764.4 (7.3)	68 (10.6)	1,074.0 (1.7)	38 (11.8)	204.8 (2.1)	19 (10.3)	7,485.6 (16.1)	11 (8.3)
Hong Kong	6,772.8 (5.7)	42 (6.6)	257.9 (0.4)	19 (5.9)	2,102.3 (21.6)	12 (6.5)	4,421.7 (9.5)	11 (8.3)
Taiwan	471.2 (0.4)	31 (4.9)	284.1 (0.4)	17 (5.3)	116.8 (1.2)	11 (5.9)	70.2 (0.2)	3 (2.3)
Korea	200.7 (0.2)	7 (1.1)	199.0 (0.3)	6 (1.9)	1.7 (**)	1 (0.5)	0	0
Southeast Asia	1,082.5 (0.9)	13 (2.0)	259.7 (0.4)	5 (1.6)	39.5 (0.4)	7 (3.8)	783.3 (1.7)	1 (0.8)
Other Asia	831.8 (0.7)	59 (9.2)	450.7 (0.7)	37 (11.5)	267.5 (2.7)	16 (8.6)	113.6 (0.2)	6 (4.5)
Africa	18.0 (**)	3 (0.5)	12.5 (**)	1 (0.3)	2.5 (**)	1 (0.5)	3.0 (**)	1 (0.8)
Middle East	275.5 (0.2)	6 (0.9)	0.0	0	124.7 (1.3)	6 (3.2)	0.0	0
Total	119,423.9	639	63,264.5	321	9,740.4	185	46,419.0	133
Of Which:								
Individuals	1,897.1 (1.6)	126 (19.7)	889.7 (1.4)	67 (20.9)	856.9 (8.8)	42 (22.7)	150.6 (0.3)	17 (12.8)
Subsidiaries	18,367.5 (15.4)	99 (15.5)	4,879.7 (7.7)	38 (11.8)	2,784.2 (28.6)	27 (14.6)	10,703.6 (23.1)	34 (25.6)

* Stock purchases with a value greater than Y100,000 only.
** Less than 0.1

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 2: Major Direct Foreign Investments in Japan by Country and Category, 1984*

(in millions of yen; share of total in parentheses)

Investor	Total		New Firms		Existing Firms		Expanded Holdings	
	Value	Cases	Value	Cases	Value	Cases	Value	Cases
United States	Y65,011.0 (53.4%)	274 (32.6%)	Y46,981.8 (66.6%)	164 (41.3%)	Y3,714.3 (27.9%)	52 (22.1%)	Y14,314.94 (40.9%)	58 (27.9%)
Canada, Central & South America	6,452.4 (5.3)	65 (7.7)	4,373.7 (6.2)	23 (5.7)	1,021.1 (5.0)	30 (13.2)	1,057.6 (3.4)	12 (5.5)
United Kingdom	7,061.1 (5.8)	73 (8.7)	2,539.6 (3.6)	24 (6.1)	3,489.8 (17.2)	38 (16.7)	1,031.7 (3.3)	11 (5.1)
West Germany	6,939.4 (5.7)	62 (7.4)	1,904.7 (2.7)	31 (7.7)	3,738.7 (18.5)	14 (6.1)	1,296.0 (4.2)	17 (7.8)
France	3,774.0 (3.1)	45 (5.4)	1,975.2 (2.8)	21 (5.4)	547.0 (2.7)	11 (4.8)	1,251.8 (4.0)	13 (6.0)
Other Europe	13,635.3 (11.2)	103 (12.2)	4,021.0 (5.7)	46 (11.6)	4,289.1 (21.2)	32 (14.0)	5,325.2 (17.2)	25 (11.5)
Hong Kong	10,226.4 (8.4)	86 (10.2)	3,668.2 (5.2)	29 (7.3)	1,840.1 (9.1)	20 (8.82)	4,718.1 (15.2)	37 (17.1)
Taiwan	3,287.1 (2.7)	40 (4.8)	1,269.8 (1.8)	27 (6.7)	638.1 (3.2)	10 (4.4)	161.7 (0.5)	3 (1.4)
Korea	730.5 (0.6)	3 (0.4)	493.8 (0.7)	1 (1.0)	236.7 (1.2)	2 (0.9)	0.0	0
Southeast Asia	1,826.2 (1.5)	15 (1.8)	1,128.7 (1.6)	14 (3.4)	0.0	0	697.5 (2.3)	1 (0.5)
Other Asia	2,556.6 (2.1)	70 (1.3)	1,481.4 (2.1)	15 (3.7)	533.6 (2.6)	15 (6.6)	541.6 (1.7)	40 (18.4)
Africa	7.2 (**)	2 (0.2)	3.1 (**)	1 (0.1)	4.1 (**)	1 (0.4)	0.0	0
Middle East	186.3 (0.2)	3 (0.4)	0.0	0	186.3 (0.9)	3 (1.3)	0.0	0
Total	121,743.4	841	70,543.2	396	20,238.9	228	30,961.3	217
Of Which:								
Individuals	3,731.6 (3.1)	183 (21.8)	1,723.6 (2.4)	73 (18.3)	1,037.4 (6.4)	63 (26.8)	970.6 (0.1)	47 (22.6)
Subsidiaries	24,213.8 (19.9)	124 (14.7)	8,731.5 (12.4)	48 (12.1)	4,576.2 (28.2)	23 (9.8)	10,906.1 (31.2)	53 (25.5)

* Stock purchases with a value greater than Y100,000 only.
** Less than 0.1

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.

Table 3: Major Direct Foreign Investments in Japan by Industry, 1984

(in millions of yen and number of cases)

Industry	Value	Cases
Agriculture	Y731.8	2
Mining	2,177.5	6
Construction	0	0
Manufacturing	26,783.5	210
Food Products	134.7	4
Tobacco Manufactures	0	0
Textile Mill Products	0	0
Apparel, Made-up Textile Products	0	0
Lumber and Wood Products	0	0
Furniture and Fixtures	73.2	2
Paper and Paper Products	41.3	1
Printing and Publishing	0	0
Chemicals and Related Products	1,138.1	8
Petroleum Refining	773.1	4
Rubber and Plastic Products	387.4	2
Leather and Leather Products	0	0
Stone, Clay, Glass and Concrete	82.1	4
Primary Metals	83.5	2
Fabricated Metal Products	4,511.7	24
Nonelectric Machinery	7,087.1	37
Electric Machinery, Electronics	8,271.3	83
Transportation Equipment	0	0
Precision, Medical, Photographic	1,382.7	17
Miscellaneous Manufactures	2,817.3	12
Transportation, Communications	10,956.9	27
Transportation	1,723.7	6
Communications	9,233.2	21
Wholesale, Retail Trade	Y53,567.1	347
Wholesale Trade	38,193.7	327
Durable Goods	22,471.5	238
Nondurable Goods	15,722.2	89
Retail Trade	15,373.4	20
Finance, Insurance, Real Estate	6,087.2	82
Finance	3,876.9	67
Insurance	1,238.9	4
Real Estate	971.4	11
Services	18,826.6	149
Business Services	12,201.3	88
Other Services	6,625.3	61
Nonclassifiable Establishments	2,612.8	18
Total	121,743.4	841

Source: Ministry of Finance, International Finance Bureau, Foreign Capital Division.